RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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December 12, 1984 **LETTER 902**

Nov. 30, DJIA 1188.94; PTI 1603; A–D Ratio –20.59
Dec. 7, DJIA 1163.27; PTI 1592; A–D Ratio –20.99

THE PICTURE: In a later section of this Letter, I present two opposing scenarios, one for the economic bulls and one for the economic bears. In my opinion, both of these scenarios make sense, both are valid, either could occur. The fact is that there were few times over the past quarter century when I could map out such convincing but opposing scenarios, and that means that I am either (1) puzzled about coming events, (2) neutral about coming events, or (3) will not try to forecast coming events.

In the last Letter I drew attention to what I termed "a line" in the Averages (meaning the D-J Industrial and Transportation Averages). A line is a narrow band of price movement lasting three weeks or longer. A line is only valid when it occurs in BOTH Averages, and, of course, this is the condition we have now. The line is created by an even division of accumulation and distribution. To put it another way, since early August (when the line formation began) the stock market has been in a state of equilibrium.

The breakout (again by BOTH Averages) from a line usually possesses primary significance. And I feel that in the current situation, the ultimate breakout of this four-month line will re-define the primary direction of the market.

Question: Russell, you've already told us that the primary trend is up. It turned up in early August when the D-J Industrial and Transportation Averages bettered their May peaks. So why are we watching this line so carefully?

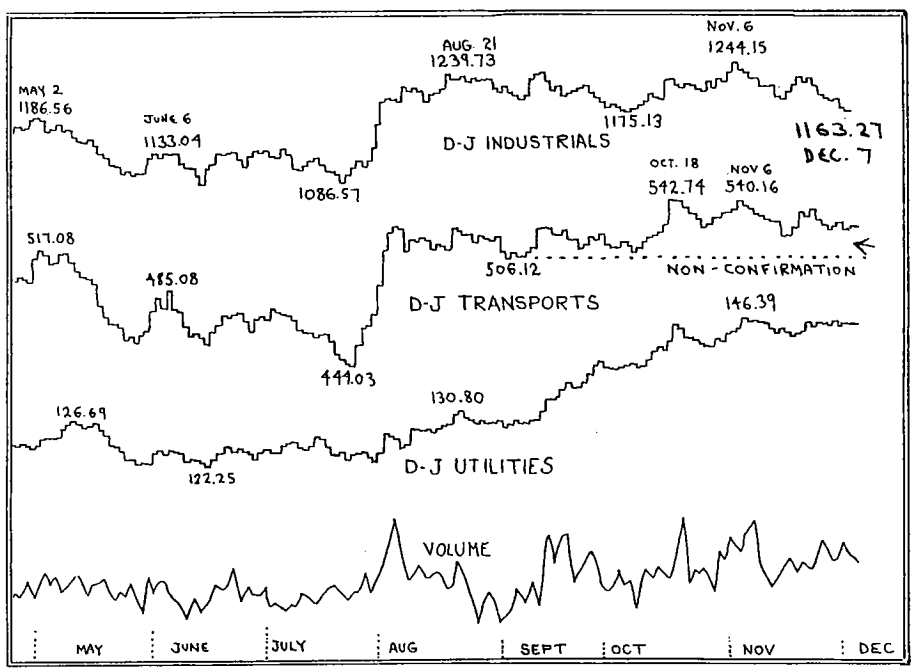
Answer: Because conditions can change! We are currently at a dramatic juncture in market history (in my opinion), and I don't want to be stubborn about what we're seeing. Think about it: we're seeing record federal deficits, we're seeing record balance-of-payments deficits, the US for the first time in 65 years has become a debtor nation (owing money to foreigners). And for the first time since the 1940's the nation is seeing deflationary conditions. Add to all that the fact that our farmers are experiencing depression conditions and our heavy industry (steel, copper, etc.) is losing out to foreign competition. Real interest rates are currently near historic highs. And finally, the Administration is not only advocating major spending cuts, but it has introduced a landmark new tax bill. Consider all these items, and is it any wonder that the forces of accumulation and distribution on Wall Street are in equilibrium? It simply means that the stock market has not made up its mind yet as to whether the coming picture is good or bad.

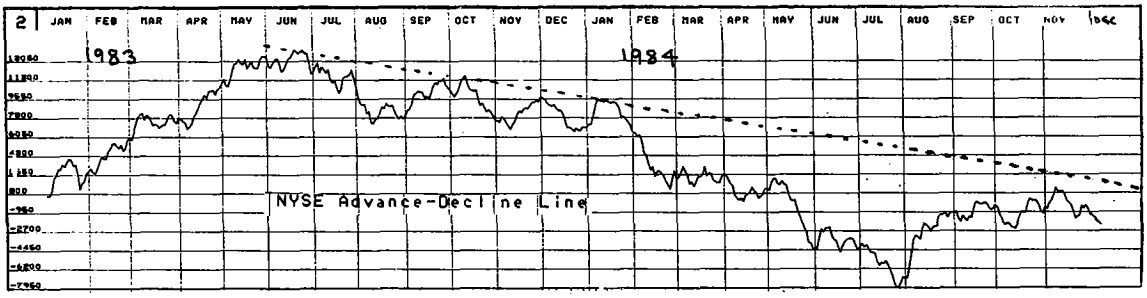
FRONT PAGE COMMENT: Since 1980 I've been saying that the forces of deflation were slowly but relentlessly overpowering the forces of inflation. Consider this: with the budget deficit of near $200 billion, we have, today, little or no inflation. But big budget deficits are supposed to be inflationary. So what's happened? What's happened is that the compounding forces of debt (which are deflationary) are now so powerful that even a $200 billion deficit is incapable of producing inflation. Furthermore, with the economy as weak as it is, can you imagine what would happen if there was suddenly no deficit? The answer is that the nation would be in depression.

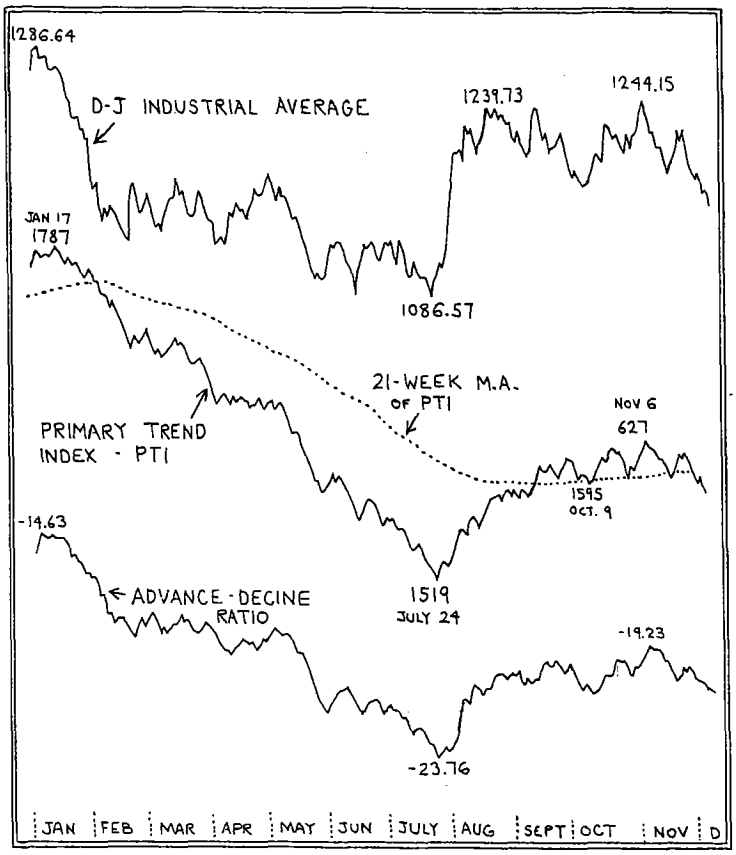
Thus it is clear that more and more debt is now producing less and less in the way of GNP and corporate profits. The profligacy of the last forty years has finally come home to roost. Keep running huge deficits and you break the nation. Eliminate the deficits and you face depression. Is there a middle ground or a painless way out? Time will tell, but I'll repeat one comment that I have made many times before. The year 1980 saw a peak in American standard of living that will stand for many years to come. From here on we start paying the piper – via higher taxes, lower real incomes, and diminishing government handouts.

Question: In an article in the December 4 New York Times a top executive in Merrill Lynch states that the public has left the market (and he ought to know). Why has this occurred?

Answer: That's easy. The public hasn't made any money in the market in over two years. All you have to do is examine the path







of the advance-decline ratio as seen on this Mansfield chart. Stocks sustained a long, costly decline from June 1983 to August 1984. But since August the rise (as measured by the A-D ratio) has been nothing much to boast about. And since September, the A-D has been moving sideways. The action of the market over the last 17 months has been an expensive "nothing" for shareholders.

Question: Russell, how does the near-term look to you?

Answer: The market "should be" over-sold, and I base this partly on the short-term trading index (STTI). This is the index that measures the average volume in advancing stocks as against the average volume in declining stocks. Any reading in this index of 1.0 or over denotes selling pressure, and a reading below 1.0 denotes buying pressure. In the 17 trading days to December 3, 14 of those days ended with the STTI over 1.0. This is an amazing string, a string seldom seen.

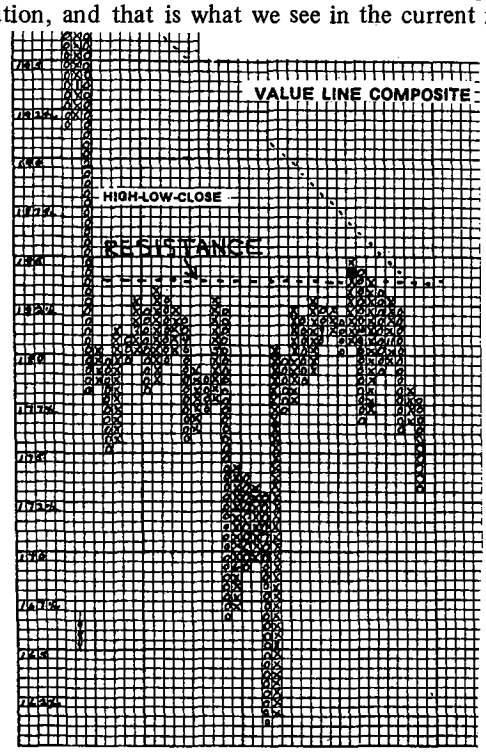
Also on December 5 the D-J Industrials closed below the lower limit of their line trading range (below 1175.13) but the Transports refused to confirm (actually, the Transportation Average has not even broken below its mid-November low of 516.00) Further, the A-D ratio failed to break to a new low on December 5, thus providing a non-confirmation against the weak Industrial Average. This kind of action "should" set up the technical conditions for a rally. If the market can't rally here, it is even weaker than it appears on the surface. To put it another way, when the market "won't do what it's supposed to do, watch out. It's telling a different story and we'd better listen carefully."

Question: What's happening to your Primary Trend Index?

Answer: The PTI has now broken below its 21-week moving average, thus turning the moving average down. On the face of it, that's my bearish signal for the PTI. On December 5, the PTI dropped to 1594, one point below the October 9 low of 1595 (see page 2 chart). The PTI measured the balance of eight critical technical indicators, and the balance of those indicators has now slid to the downside. This is enough so that I have now taken the bull out of the box, and I rate the market neutral/bearish. Any further decline in the PTI will label the market decisively bearish, as far as my reading of the PTI is concerned.

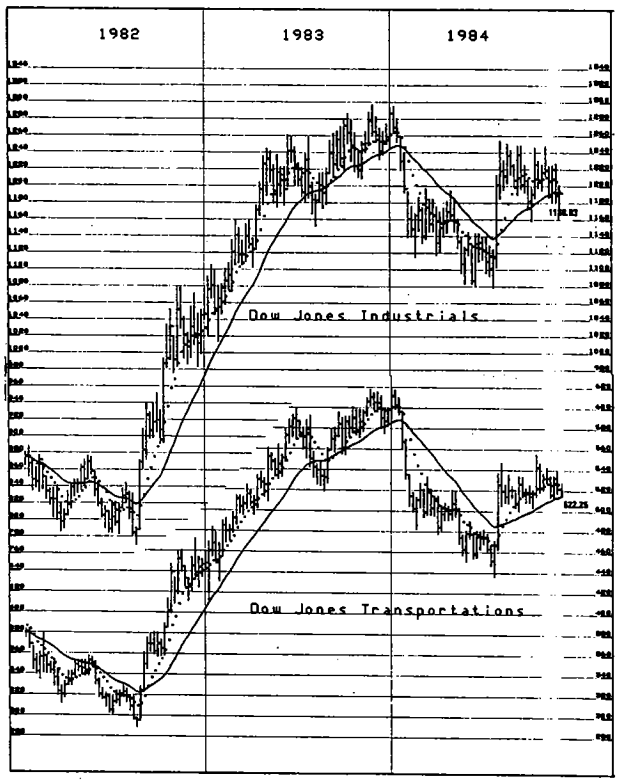
At this point I want to review a few charts now, because I feel that these charts will go a long way towards explaining what is happening during this confusing period.

The first chart (courtesy of Chartcraft, Larchmont, NY) shows that broad Value Line Composite (containing over 1600 stocks). This chart indicates accumulation throughout most of 1984. The Value Line assumed the form of a huge head-and-shoulders bottom, and this, of course, was encouraging. But there have been cases where large areas of accumulation have ultimately given way to distribution, and that is what we see in the current instance.



Note that during September (solid black box) the Value Line broke out above the resistance line (the resistance came in at 184). Following that breakout, the Value Line broke below its last low (below 177). That break resulted in a bearish designation for the Value Line (see last Letter). Last week the Value Line shattered all its lows back to September, and any semblance to a right shoulder was destroyed. The Value Line pattern is now unmistakably bearish. The Value Line is the broadest and the weakest of the major averages, and it has been leading this market down.

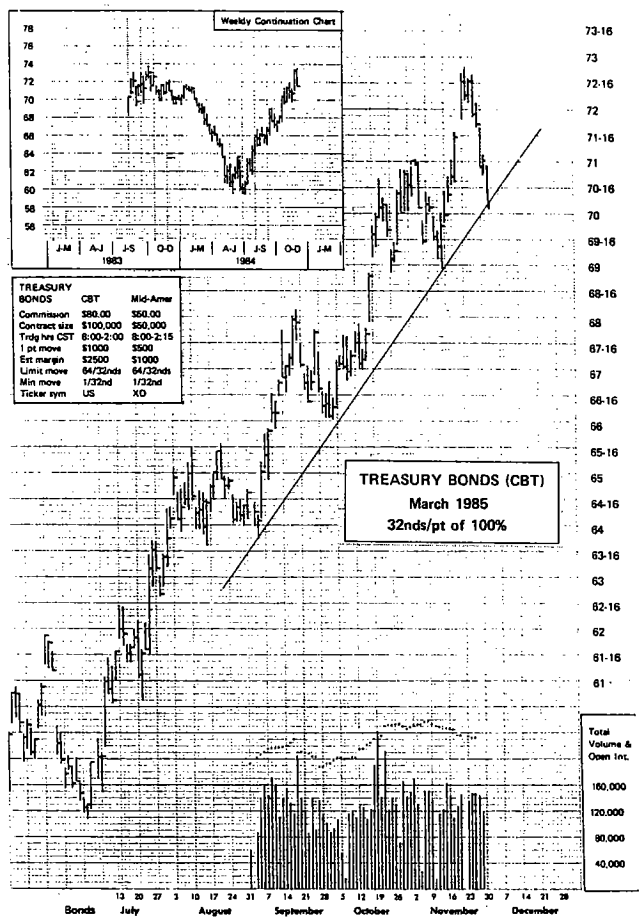
Here is a weekly chart of the D-J Industrial and Transportation Averages, and this chart provides an excellent overview of the current situation. You can see that the great bulk of the upside action of 1984 (and this is really incredible) took place during a single week in August. Since then, the Averages have been fluctuating within the line formation.



The longer-term moving averages are shown on the chart (solid line), and note that the Industrial Average is now below its moving average (the moving average stands at 1190). The moving average for the Transports stands at 513, so the Transports are still holding above their own moving average.

The Transports, so far, have been the island of strength in this market, but the first sign of confirming trouble would be a Transport drop below the MA at 513, and then a drop below the lower limits of the line at 506.12. (Chart courtesy of Mansfield).

Perhaps the most critical picture of all is this chart of the Treasury bonds (March contract). Note that following new highs just under 73, the T-bonds have declined, and for the FIRST TIME on the current decline the bonds have sunk below a previous top. December 7 saw the March contract crack slightly below the long rising trendline, and this is the second danger signal (the first being the drop below the November top). The worst action we could see now would be a drop on the March bonds to 69, then a rally and a new decline. This would trace out



a large head-and-shoulders top, and I kind of think that's what we could get.

With the economy sloppy, of course, the last thing Washington wants is rising interest rates. But sliding bonds mean rising rates, and it's beginning to happen.

INVESTMENT POSITION: The D-J Transportation Average hasn't broken its 506.12 low yet. The A-D ratio hasn't dropped below its October low yet. But the PTI is below its 21-week moving average and is beginning to trace out a downtrend, and for that reason I have yanked the bull out of the box. The bear is beginning to show, and I've put just his head in the box–not the whole bear yet, but just the head.

I would lighten up on equities now, or at least walk quietly toward the exits. If the downtrend in the PTI becomes more decisive, there will be no doubt that the bear is about to take over.

Bonds appear "iffy" with a sell signal coming if the March T-bond contract drops below 70. As for gold, the December 6 announcement that Deak & Co. (one of the largest foreign currency and precious metals trading companies) has filed for Chapter 11 may tell us all we need to know.

And speaking of troubles, Prudential-Bache showed a 9-month loss of $104 million, thought to be the biggest loss ever suffered by a full service firm. When Wall Street bleeds (and it is bleeding), the rest of the nation is usually not too far behind.

THOUGHTS ON WHERE WE ARE: Politics are going to play a huge part in the 1985-86 picture for the US, maybe the biggest part in decades. But first I'm going to present what I consider to be the bullish and then the bearish scenario.

BULLISH SCENARIO: Lower current interest rates stimulate the economy sufficiently to turn today's minor slide into just that – a temporary decline in a basically expanding economic situation. Congress compromises on some minor tax increases which seem politically acceptable. The Department of Energy and Education are shut down and $60 billion is trimmed from the Federal budget.

The dollar stays strong since world interest rates are declining in tandem with US interest rates, leaving the dollar still attractive in terms of real return. The whole "flat tax" argument is put off by Congress "until 1988" and to everyone's surprise the stock market likes that.

Consumers grow progressively more bullish, and consumer spending increases, following an excellent 1984 Christmas. The stock market backs and fills, then proceeds to grind up throughout most of 1985. Meanwhile, somehow the whole deficit/balance-of-payments situation appears to sit on hold. Long-term bond yields stabilize in the 11-12% range, and apprehension in the money markets turns to confidence. Fed Chairman Volcker announces he will "stay on" until 1988. The bull market continues on Wall Street.

BEARISH SCENARIO: Corporate profits continue to drop during the fourth quarter of 1984, then they plunge as 1985 gets underway. In the face of an unexpectedly severe slide in both personal and corporate tax collections, the federal budget heads toward $300 billion or more. Responding to expanding federal financing, the bond market turns dramatically lower, and by May 1985 long-term Treasury yields push to the 13% range. By summer, T-bond yields near 15% as the worst recession of the post WW II era is on.

The stock market gives a bear signal towards the end of December and heads down with a vengeance. The dollar suddenly turns weak (despite rising US interest rates), and foreigners start to dump notes and bonds on the US market. The Treasury calls for emergency measures as its tax receipts collapse, and there is panic on Wall Street. Commodities, gold, silver, sales, housing starts and employment all head down. The US and the world are in the throes of a major bear market.

Next thought: Somewhere ahead Fed Chairman Volcker has to make a decision. The decision will concern staying on the job or quitting while he is ahead. Volcker obviously knows that his job will get more difficult from here on. Volcker has been lucky or very bright or both so far, in that he has had the Fed walk the monetary tightrope—and the economy has not fallen off the ledge. But Volcker must wonder how long his luck can hold. So the question: should he patriotically stay on the job, or should he quit and walk into a great position in private industry (probably at one of the major investment banking firms)? If Volcker leaves, the markets are not going to like it. Volcker, despite many Volcker-haters, has the respect of Wall Street, the nation—and, most importantly, Congress!

Fiscal thought: Reagan has announced to the world that he will not raise taxes. He has also said that he will not cut the two major federal expenses, Social Security and the military. The third biggest expense, interest on carrying the federal debt, Reagan can't cut. What's left? Not much in the way of major targets. Furthermore, any list of draconian spending cuts will probably not win Congressional approval, especially since Tip O'Neill still runs the House.

This piece from the Nov. 26 Washington Post (by Michael Barone) presents the picture as far as Washington is concerned. My own thought is that Washington may get shockingly little done during 1985. The fact is that the House Democrats may want Reagan to stew in his own juices, and the Senate has become a collection of sectional interests each one devoted to his own constituency. In fact, the New York Times (Nov. 25 and 26) ran a series on the demise of statesmanship and leadership in the Senate. The jist of the series was that whereas the Senate was once a center of masterful and patriotic debate of major issues, it's now a group of little men working on the basis of "every man for himself."

> **WASHINGTON, Nov. 24 — The United States Senate was created as a legislative aristocracy whose members' six-year terms would insulate them from passing political passions. In the view of many senators, however, it has degenerated into a raucous town meeting, focusing on narrow issues of the moment rather than the broad policy decisions envisioned by the founding fathers.**
>
> **To many senators, nothing sounded the alarm so clearly as the tumultuous closing days and nights of the session last month, when members arose from gym cots in predawn hours to vote on hundreds of amendments to a money bill so complex that few, if any, knew what they were voting on.**
>
> **"We are witnessing the disintegration of the U.S. Senate," said Senator Dan Quayle, Republican of Indiana. He is chairman of a committee that has been studying the chamber and hopes to complete recommendations for reform in the next few days.**

Balance-of-payments thoughts: The BOP deficit this year, for the first time in US history, is going to go over $100 billion—probably to around $130 billion! Thus 65 years of BOP surplusses are going out the window in 1985 as the US finally becomes a debtor nation.

There are four major swords hanging over our fiscal heads today. (1) the US BOP deficits, (2) the federal budget deficits, (3) the emerging US indebtedness to the rest of the world, and (4) the Third World debt crisis, a crisis which directly affects US banks. The four problems may serve to reinforce each other. And I wonder how long the effect of one or all these problems can be held off?

Item: the first figures for the latest fiscal year have come in, and they show a $28.9 billion federal deficit for October. On an annualized basis this would be $346.8 billion. Of course such a total could never occur—or could it?

TAX BILL: Many sophisticated commentators believe that any new tax bill (including the new Treasury bill) has a rather slim chance of passing. One reason is that it would take a major Presidential commitment and major cooperation in Congress to pass the bill (if it is indeed passable). Congressmen ask, "Why should I get into a huge battle for a revenue neutral bill? The real problem is the deficit, and the new tax bill doesn't address that problem."

A second reason for skepticism on the bill is that Senator Robert Packwood has just been handed the chairmanship of the tax-writing Finance Committee. Packwood is an advocate of tax

breaks to stimulate business, and the new Treasury bill does just the opposite. Furthermore, Senator Robert Dole, now majority leader of the Senate, tends to view taxes in the same way as Packwood does, and this too suggests that it will be very tough to get a flat tax through the Senate.

A third problem for the Treasury tax: this tax would require cutting back on deductions of state and local income taxes and cutting tax benefits that serve important national goals such as retirement, health, housing, funding for state and local governments. All of these are furiously defended by some of the most powerful lobbies in Washington.

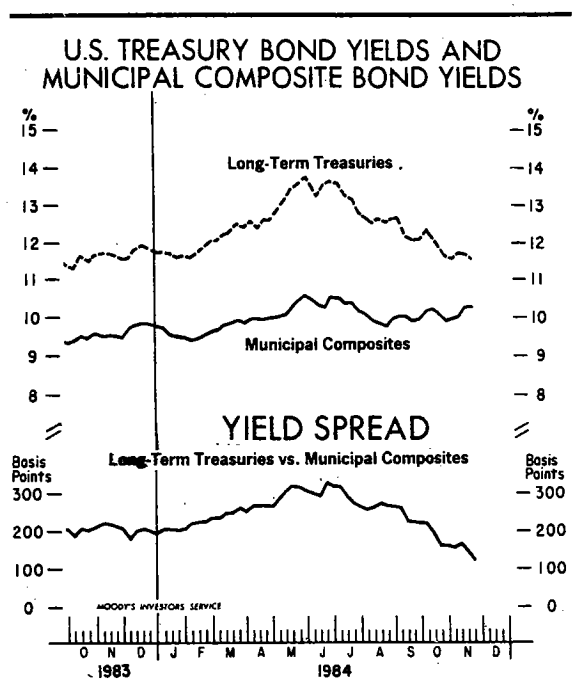
Next, I want to say, "Thank you dear Providence for the Wall Street Journal." As usual, the Journal produces the great economic pieces. In a Dec. 6 article by former Assistant Treasury Secretary Craig Roberts, the real meaning of the new tax bill is revealed. The article is entitled, "A Tax Scheme to Deindustrialize America." I include a few cogent paragraphs from this brilliant piece:

> Unfortunately, Treasury's tax reform went in the opposite direction and substantially raises the cost of capital by greatly lengthening the write-off period and adopting a slower write-off rate than straight line. ACRS and the investment tax credit (ITC) are replaced with "economic depreciation," based on the hypothetical concept of the "annual loss in the value of a capital investment over its economic life." Since no one can know in advance the economic life of different investments in machinery and structures or the pattern of the loss of value over that life, economic depreciation gives the bureaucracy the power to classify assets and assign economic lives for depreciation purposes in an entirely arbitrary manner. The main beneficiaries of the Treasury's proposal are law and accounting firms with no depreciable assets—which is hardly surprising as the proposal was drafted by lawyers and accountants.
>
> If the Treasury's proposal were to be implemented in its present form, the U.S. would be deindustrialized within a decade. Every category of capital equipment and every manufacturer would be harmed by the proposal. Since the so-called "smokestack" industries are particularly hard hit, the Treasury proposal amounts to an industrial policy designed to accelerate the transformation to a service economy. The obvious implication is that the Treasury bureaucracy has no idea of the economic impact of its proposal.

MUNICIPAL BONDS: With the emergence of the possible "flat tax," the buyers and holders of munis are in a state of puzzlement. The question: if the ceiling on individual income taxes is reduced to 35% instead of the current 50%, wouldn't muni bonds (which are exempt from federal taxes and also exempt from state taxes if the buyer resides within that state) be worth less? After all, if I receive a 9% yield on a muni bond and I'm in the 50% tax bracket, I have to earn roughly 18% on another investment to equal the net return on a 9% muni. But if I suddenly drop to a 35% tax bracket, the tax exempt status of the muni is worth less. Right? Yes, that's right, the muni is worth less.

But, the markets are never asleep. The function of any market is to discount the future, and in my opinion, that is what muni bonds have been doing. This chart tells the story. Here we see the yield spread between long-term Treasury bonds and the Moody's Muni Composite. As you can see, the spread has recently dropped to a differential of only 1.8% points, down from 3.6% points in mid-year. Actually, to put it in even more practical terms, the yield on 20-year T-bonds is now about 11.4%. Last week I bought some California general obligation bonds (full faith and credit of the state of California) to yield 9.7%. Thus, for a fully tax-free AA rated bond, I give up only 1.1% in interest over a T-bond that is taxable.

It is my opinion that the muni market has already discounted at least part of the possibility of a flat tax (and I am doubtful that a flat tax will pass). On top of the flat tax scare, California had its Proposition 36 scare (the proposition was defeated). On top of all this, the deductibility of industrial revenue muni bonds may be stripped away under the new bill, so there has been a rush to sell these bonds in 1984, and this glut has added to pressure on muni bonds.



The upshot is that top quality muni bonds now offer yields that are within 2 percentage points of Treasury bonds, yet one is tax exempt and the other is taxable. I continue to think that, all things considered, muni bonds are attractive. However, I continue to prefer the general obligation of bonds, and I personally avoid insured bonds. If a bond needs insurance, I don't want it.

Here's an interesting thought. In the 50% tax bracket, you have to make 20% to equal the return on a muni bond yielding 10%. So in a five year period, a 10% yielding muni bond would return more than 50% (compounded). To equal that you would have to make 20% during each of the five years or over 100% in total. To me, that's another way of saying that in the 50% bracket you're home free with a muni bond yielding 10%. In other words, at the end of five years you've got your money back, and you still have your bonds (at whatever price they are selling for then).

NOTES & QUOTES: Russell trivia: What is the oldest and most misspelled government service? The Marshals Service (they work for the courts). And no, there's no apostrophe and no, there are not two l's in Marshals. What two mammals have no belly buttons? You give up, the platypus and the echidna. They are the

only two mammals that are hatched from eggs–thus no umbilical cords.

* *

Statistics: The average American family is worth $25,000. But most of that net worth is in inflated home prices. Without their home values, HALF of all US families would have no net worth at all. This gives you an idea of what could happen if deflation takes over.

> According to a current government survey, 2% of Americans own 39% of all taxable bonds, 23% of all money held in checking accounts, 8% of all money in savings accounts and 15% of all money in money market accounts and C/D's.

* *

Financial News Network called and asked me if I would be on their program for the big last day of the year. I said I would. They asked me who I would like with me, and I said, "Let's make it a real show, I want my old friend, Joe Granville." And a few days later Joe called to say, "Great, I'll be there."

So on December 31 at 1PM Pacific Standard Time, Joe and I will be on FNN for a full hour. Take a look; it may be the perfect way to wind up your 1984.

As a point of interest, this business isn't known for conformity. For instance, Joe Granville is now predicting the biggest bear market since 1929. And Bob Prechter (Eilliott Wave Theorist) is talking about the biggest bull market ever. Me, I just beat my brains out trying to identify the prevailing trend. My 1984-85 message to Wall Street: "Give me a break!"

* *

As subscribers know, I follow a lot of economists, and one of the best records belongs to the Levys who write "Industry Forecasts" (Box 26, Chappaqua, NY 10514). Their latest report is hardly comforting. Here are a few quotes: "This recession will deepen when underoccupied rental buildings along with the contents of warehouses and stores become 'distress merchandise'. " "Shrinking profits will be the major deflationary force. Company after company will be compelled to cut prices in order to sell their products or services in an increasingly competitive environment." "Second quarter 1985 profits will be down about 40% from a year earlier. This decline will be the worst since the one that began in 1929."

My comment: So far, I feel the economic news could be bearing out the Levy analysis. Orders for non-defense capital goods slumped 9.3% in October, the third down-month. US auto sales (which should be up each 10 days of any given month) fell 14.2% in the last third of November, a bad sign.

But I keep coming back to this thought: if we go into recession in 1985, there is going to be a huge tax short-fall to the Treasury. That tax short-fall will produce a budget deficit that could go over $250 billion. Under such conditions, bond prices could slump, producing a sharply rising trend in interest rates (could this be why signs of a top are now appearing in the bonds?).

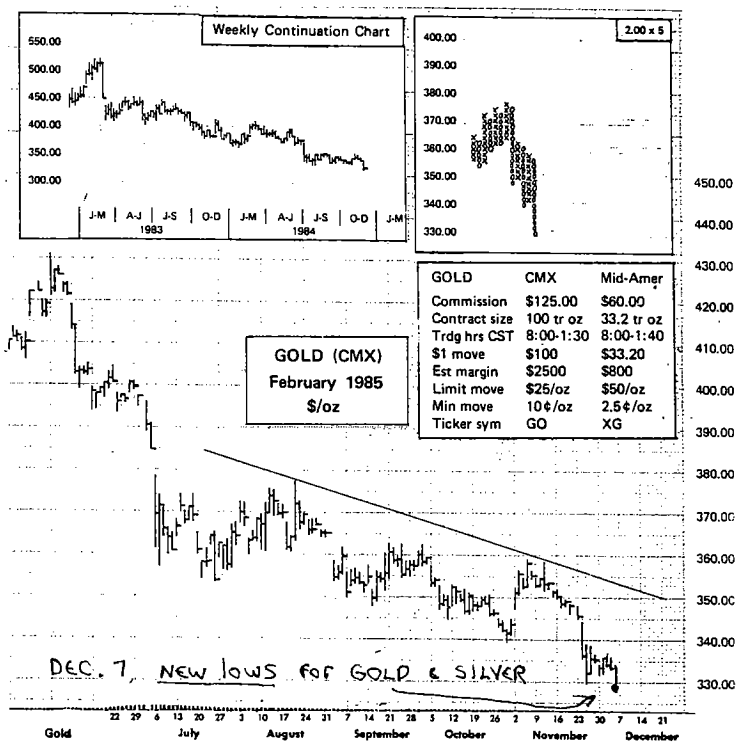
Also, if the country goes into recession, there will be (alas) terrific resistance to cutting federal expenses, particularly transfer payments. Also, a recession would hurt any plans to broaden or raise taxes. To put it another way, a recession (if it comes) could not have picked a worse time to materialize.

FOR NEW YORK SUBSCRIBERS: In accordance with the New York Investment Advisors Act, we have filed our Investment Advisor Statement and New York subscribers may obtain a copy of same upon request. A fee of $14 will be charged for xerox costs.

GOLD: The persistence of bullishness and optimism towards gold is almost unbelievable. Here's gold at or near new contract and spot lows, and the hard money advisors keep talking about "a major bottom" or the "nearness of the next major bull market in the metals." Maybe they're right, but the practice of guessing at major bottoms is the ticket to bankruptcy. As for me, I just hope I'm smart enough to *recognize* the gold bottom when it finally arrives, but I know that averaging down in a bear market is tantamount to taking a seat on the down-escalator at Macy's.

This Dunn and Hargitt daily chart shows you the action of gold to the present, and it is clear that it will take a rally above 350 to justify the bullish hopes. On the reality side, December 7 saw new lows in both gold and silver (see chart below).

One reason for the stubborn hopefulness towards gold is the well nigh unshakable belief among many that "inflation will shortly rise again." In my book, that comes under my category of "dangerous preconceived notions" or "deceptive scenarios." In this business, it's very dangerous to bank on your personal theory of what must happen next year. The gold-philes have been doing that ever since 1981, and see what it's done for them. Personally, I've been thinking that deflation may be the surprise in America's future. So far, the markets haven't proved me an idiot.



LATE NOTES: As of December 7, the short-term trading index registered 16 of the past 22 days as in the selling pressure area. That at least hints of an over-sold market. On top of that, neither the Transports nor the Utilities have confirmed the Industrial Average's break below the lower limits of the line. But the PTI closed the week at a new low for the move at 1592. The technical mystery deepens, but I can't ignore the poor PTI action. The bears are gaining strength.